

# The Role of the Audit Committee Regarding Non-Audited Information

**Paper prepared for the Audit Committee Chair Forum**

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The Audit Committee Chair Forum (ACCF) is convened by the CBI and Ernst & Young and is facilitated by Cranfield University.

The Forum comprises a select group of audit committee chairs from the UK's leading companies. Our aim is twofold, namely:

- to influence the direction of regulation as it impacts audit committees, and
- to act as a vehicle to develop points of view and best practice.

The Forum provides an opportunity to contribute to the debate, influence its direction and improve the performance of audit committees.

The Forum is currently chaired by John Buchanan, Audit Committee Chairman of AstraZeneca, with Gerald Russell, Senior Partner at Ernst & Young, and Martin Broughton, President of the CBI.

This is the seventh paper produced by the ACCF. Previous papers include:

- The role and function of the Audit Committee
- The drivers of audit quality
- What is an effective audit and how can you tell?
- Audit Committee regulation: 'Financial literacy' – what does it mean?
- Audit Committee Communication: What is said, why, how and to whom?
- The role of the Audit Committee in Risk Management

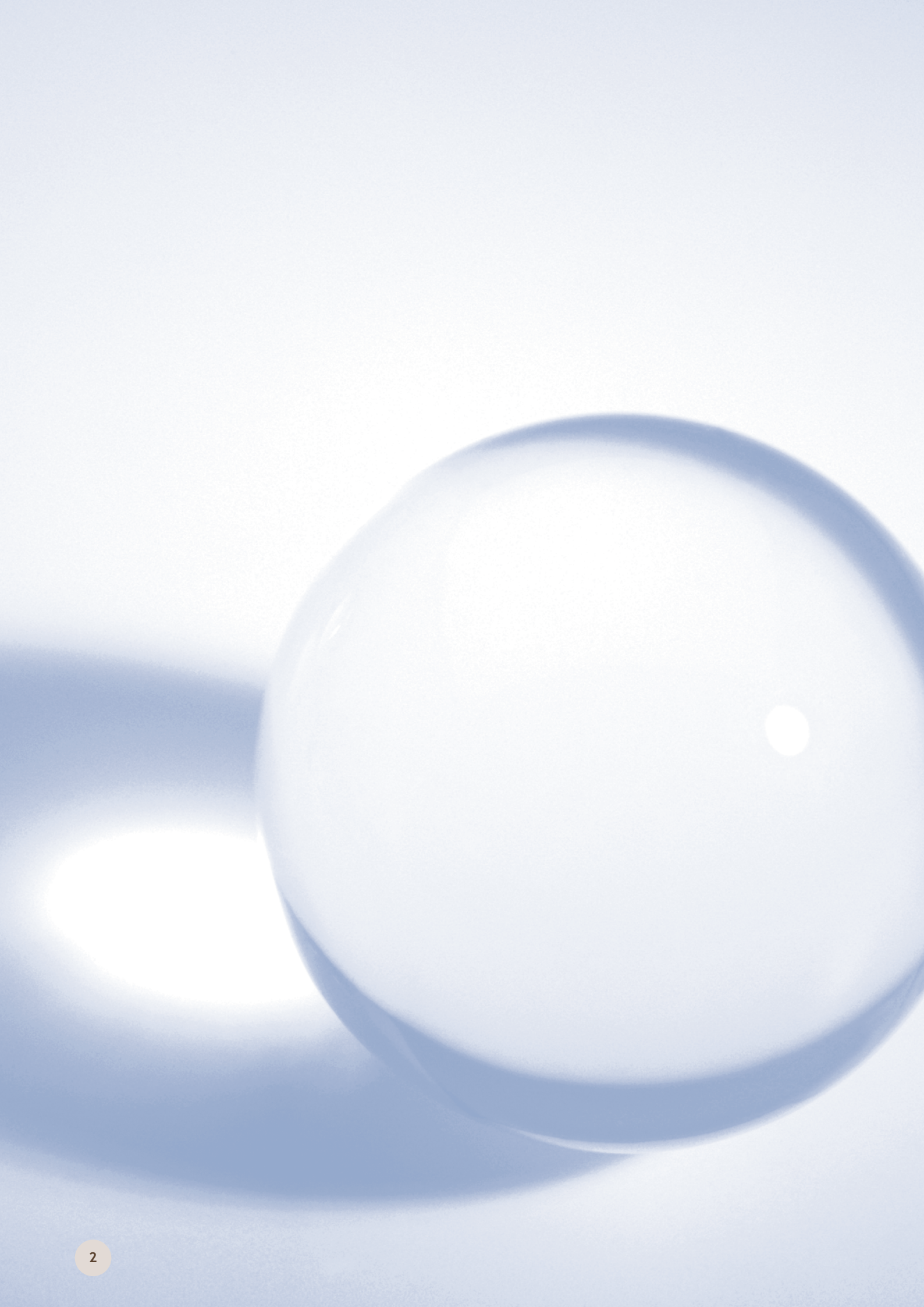
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## Executive Summary

- The volume of non-audited information released by companies is extensive, and growing. This information has the power to move the share price. However, there are few regulations concerning this information, and practices differ widely.
- The tone of such information is often as important as the underlying content.
- A hierarchy of oversight is necessary. Not all of the information disclosed should or could be reviewed by non executives. Companies have to determine the significance of each statement and judge whether it is a matter for Board review, for delegation to the audit committee, or for the executive management. The Board should confirm that appropriate processes are in place to ensure the probity of the disclosures.
- Narrative disclosures in the financial statements are generally reviewed in some detail by the Board and the audit committee.
- The preliminary statement of results is reviewed by either the Board or the audit committee, or both. Particular attention is paid to the tone and outlook of this document.
- The level of review of interim statements by audit committees varies between companies.
- The level of audit committee or non executive involvement in the pre-close statement also differs significantly between companies.
- Practices regarding investor/analyst presentations vary. In a few companies the non executives see both the slides and the scripts for the presentation before the event, and have the time to make comments. However, in a significant number of organisations there is little non executive input or review. This was seen as a matter for some concern.
- It was felt that it would be useful for there to be broad guidelines concerning what is expected with regard to the non-audited information in investor/analyst presentations and in the pre-close statement. This would be of use to non executives and also to finance directors. However, it would be inappropriate for standards or regulations to be introduced in this area.







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## Introduction

Much of the information on which market participants base their decisions is not audited. This includes: narrative disclosures in the financial statements; pre-close trading statements; the preliminary results; investor and analyst presentations; the company's website; and non-accounting data that are key indicators in various industries, such as forward order books (construction), sales per square foot (retail), drugs pipeline (pharma) and reserves (oil).

The release of such information can have a significant impact on a company's share price. Indeed, this is likely to be more significant than the effect, at a later date, of issuing the audited figures.

This paper reflects the discussions of a meeting of the Audit Committee Chair Forum (ACCF) held on 8th November 2007 to address the role of the audit committee as regards non-audited information. Additionally it draws upon telephone interviews with four members of the ACCF (all of whom attended the subsequent meeting), discussions with practitioners, and a selective review of relevant publications.

The interviews and meeting directly related to this matter solicited the views of nine Chairs of the audit committees of leading companies and four audit partners from Ernst & Young.

The questions addressed in the briefing document circulated prior to the ACCF meeting, which set the agenda for the meeting, are set out in Appendix 1.

The briefing document also included some examples of non-audited information, as shown in Appendix 2.



# Verifying Non-Audited Information: The Regulatory Background

*“As a Board, are we prepared to take the risk of price-sensitive information going out that is incorrect? How much risk are we prepared to take?”*

## Auditors' responsibilities

Although most of the non-audited information is not subject to external examination, this is not always the case for information included in the financial statements. A company's external auditors have a role in reviewing some of the non-audited information included in the company's annual report and financial statements.

Section 496 of the Companies Act 2006 states:

*“The auditor must state in his report on the company's annual accounts whether in his opinion the information given in the directors' report for the financial year for which the accounts are prepared is consistent with those accounts.”*

For these purposes information in the directors' report includes information that is included by way of cross-reference to other information presented separately from the directors' report.

The auditors' duty is extended by the International Standards on Auditing, which require the auditor to read the other information in the annual report and identify material inconsistencies with the audited financial statements (ISA 720). Also, should they become aware of any misstatements of fact in that non-audited information, the auditors have a responsibility to deal with that.

Although this might seem to mean that the auditors are, by implication, confirming the probity of the published information, this is not the case. Much of the narrative disclosure in the annual report is not directly linked to the audited financial statements, and so the auditors have no formal responsibility in this regard.

## Audit committee's responsibilities

The Smith Guidance on audit committees includes the following within the main roles and responsibilities of the audit committee:

*“to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them”*<sup>1</sup>

This reference to formal announcements means that there is a role for the committee to play in the release of financial information beyond the annual and interim financial statements.

<sup>1</sup> Financial Reporting Council, 2003. (Emphasis added.)



## The US Position: The Disclosure Committee

In the United States, following the Sarbanes-Oxley Act of 2002, companies have a disclosure committee charged with considering the processes surrounding the non-audited information presented by a company. A disclosure committee is an executive committee, comprising senior management and reporting to other senior management or to the Board. It will include, for example, officers from finance, legal, risk management, and investor relations. Non executives do not sit on the disclosure committee, although they may receive reports from it.

Appendix 3 sets out more information about the role of the disclosure committee in the USA.

Of the companies discussed by ACCF members, four had US listings and so had to have disclosure committees. A further two companies chose to have disclosure committees.



## The Roles of the Board, the Audit Committee and the Executive

*“Is the audit committee’s role to ensure that there is a process for those other documents, or to put them through the same level of scrutiny as the audited accounts? I would be quite uncomfortable with the latter.”*

*“Tone is a Board responsibility, not an audit committee responsibility. And verification is an executive disclosure committee responsibility.”*

It was broadly agreed by all participants that the probity of price-sensitive information released by a company is a matter for its Board. In some instances, part of the duties surrounding this are delegated to the audit committee. However, it was acknowledged that there is now a continuous flow of information to the markets throughout the year, and this committee of non executives does not have the capacity to review all non-audited information, nor indeed is this its function. This would not be an appropriate use of the audit committee’s time and resources. The responsibility for preparing the information, and ensuring that appropriate systems are set up to govern its integrity, lies with the executive.

The Board and the audit committee should ensure that suitable processes have been devised and are being followed, particularly as regards ‘set-piece’ disclosures such as those considered in this paper. In companies where there is a disclosure committee, that committee forms part of these underlying processes. Companies without disclosure committees should have other mechanisms, and the internal audit function may play a role in this.

*“All of the figures come up through a process. All the disclosure committee does is formalise that process, with a degree of checking, and an individual in charge.”*

Different aspects of non-audited information have different market impacts, and demand different underlying processes. One ACCF member described this as a “hierarchy of oversight”, with some matters being ‘checked’, others being ‘verified’ and others still being externally verified. The minimum requirement would be for the audit committee to be reassured that a process is in place; in some instances, the normal processes of internal audit will be sufficient to do this.

The type of information subject to review or verification, and the level of that scrutiny, will vary with the nature of the business. For example, the focus in construction companies might be on contracts, in oil companies it might be on reserves. The Board will be aware of these ‘soft spots’ and should ensure that they are on the agenda.

## A Wide Range of Practices

During the discussions, detailed experience of more than 15 major companies was compared, and the variety of practices encountered was significant. The discussion ranged around what was done in different companies, and what could or should be done. The following paragraphs consider the practices in operation for each aspect of the non-audited information, with more significant aspects discussed first.

### Narrative disclosures in the financial statements

*“We [the audit committee] sign off the back end and read the front end. ... At the end of the day the front end is a bit of a marketing document, and so the CEO and Board need to deal with it.”*

Narrative disclosures are a critical part of the financial statements, particularly since the introduction of International Financial Reporting Standards (IFRS) which have added to the complexity of the financial information. As such, their tone and content are taken seriously by the Board, and are subject to detailed review.

The procedures underlying this review varied between companies. Although the tone was always seen as a Board matter, in some the content too was reviewed by the full Board; in other companies the review of the content of the ‘front of the book’ was delegated to the audit committee, with the chair of that committee ensuring that s/he read every word.

Where a disclosure committee (of executives) existed, the content of the narrative disclosures underwent a formal verification procedure, and was fully documented in a supporting file. However, even in companies where the procedures were less formalised, some ACCF participants took the view that the content would still be traceable to underlying documentation, although this was not specifically being checked.

*“You rest on the trust of your executives.”*

The Companies Act 2006 extended the narrative disclosure requirements, but introduced a ‘safe harbour’ provision for the directors’ report and the directors’ remuneration report, whereby directors are only liable for statements made recklessly or in bad faith. Although some companies have not considered this in detail yet, others are taking the view that much of their narrative information will go into this part of the annual report or will be cross-referenced to it, to take advantage of these safe harbour provisions.



## The investor and analyst presentations

*“You don’t want to live through that moment when your share price drops 25% because you gave out a bit of information that was wrong.”*

*“If it went wrong and you hadn’t seen it, it would look very reckless.”*

Much of the time at the ACCF meeting was spent discussing the investor and analyst presentations, which fundamentally affect the way a company is perceived. It was noted that in recent years such presentations have been published on companies’ websites. Because of this they have taken on new significance as the information is a matter of public record and cannot easily be retracted or changed.

Practices varied considerably regarding the review of the tone and content of these presentations.

Those present at the ACCF meeting considered that it was good practice for the full Board to receive a copy of the slide presentations in advance, and that this good practice could be improved upon if the Board were also given – in writing or orally – the CEO’s and finance director’s (FD’s) scripts that would accompany those slides.

In some companies, the Board did have the chance to see the presentation in advance, and to comment upon it. In others, the Board only saw the presentation after the event. In one company, the practice was that one or more of the non executive directors (NEDs) occasionally sat in on one of the presentations, to see what was being said to investors and analysts. In some companies, the presentations were not examined at all by non executives, although one audit committee chair commented that in his company this practice was being reconsidered, and more NED involvement was likely: “It’s just become apparent that we need to do something.”

For the companies with disclosure committees, those committees reviewed all of the numbers and statements to be included in the presentation, and this review was documented. In one case it was reported that the Q&A crib sheet for the presentations also went through the disclosure committee. In companies where there was not a disclosure committee it was sometimes the case that key information (for example, details of the forward order book) was verified and documented. Again, there was a general presumption that even if there was no formal review of underlying documentation, such documentation did exist.

*“It’s a big red flag if you’ve not finalised the investor presentation until less than 24 hours before it’s due.”*

One practical problem with a non executive review of the investor presentation is the timescale in which it is put together. In some companies, this is a very hectic schedule, and the material is constantly changing. It was noted that this dynamic situation, with changes being made at the last minute, is often where mistakes can take place.

In some of the companies neither the Board nor the audit committee saw the presentation in advance; the NEDs were not comfortable with this situation. Often, it arose because the CEO was changing the presentation up to the last possible minute, in order to shade the way the results would be seen by the investors. Some CEOs were seen to take it almost as a personal challenge if the non executives requested prior sight of the investor presentations.

In all of the interviews and discussions held by the ACCF on a variety of subjects, the audit committee chairs have expressed their trust in the executives of their companies. Nevertheless, a phrase frequently used by ACCF members in this respect is “Trust, but trust with verification”. This sentiment was reflected markedly in the feeling of this meeting. It was agreed that it would be preferable if it became standard practice for presentations to be reviewed in advance.

As the executives are delivering the presentation on behalf of the Board, the non executives took a keen interest in knowing what was being said and, in particular, understanding and approving the tone of the statements. A Board sign-off in advance could be seen as good governance. Furthermore, such a practice could also benefit the finance director. The comment was made that in some companies, finance directors may prefer to present a neutral, rather than bullish, picture of the results, and non executive influence could support them in this.

## The preliminary statement

*“It goes through the mangle.”*

The preliminary statement of the company’s results for the year is a critical document. Although it is itself not audited, all of the underlying data have been audited, and the statement reflects what is effectively audited information. Indeed, the eventual audit report is generally dated on the same date as this statement’s release. Certainly, the market tends to assume that it reflects what the audited accounts will eventually show, which highlights its importance.

In all of the companies discussed, the whole Board saw the preliminary results before the document was issued to the markets. In some cases the numbers were reviewed in detail by the audit committee prior to the Board meeting, with a presentation from the finance director. In other companies this presentation and review was done at the Board meeting. Non executive directors were particularly interested in the tone of the preliminary statement, as this affects how the document is understood by investors and analysts.

## The pre-close trading statement

*“At [Company] we are going to spend hours poring over the preliminaries. But nothing like that on the pre-close trading statement.”*

The pre-close trading statement is an important release to the markets. However, although some companies had a Board meeting to consider the wording of this document before it was finalised, in others the non executives had little or no input into what information was given and how it was phrased. The ACCF members considered that it would be useful for non executives to review the statement before its release.

## Other disclosures

*“You need to ask yourself, am I comfortable with that number?”*

Three other types of non-audited disclosure were considered briefly: non-GAAP figures, the quarterly reports and interim management statements, and the corporate website.

### Non-GAAP figures

There has been a growing trend in recent years for companies to disclose non-GAAP figures, such as EBITDA<sup>2</sup>, or an ‘underlying’ earnings figure which reverses some of the more complex effects of IFRS. Although such figures are based on audited information, they themselves are not audited. Nonetheless, they are often seized upon by analysts and investors as a key to understanding the company’s results.

It was agreed by those present that the audit committee should be aware of the reconciliation between the audited and non-GAAP figures. Furthermore, an opinion was expressed that it is useful to have a written protocol, agreed by the audit committee, which describes the adjustments and ensures consistency in disclosures year on year.

### Interim and quarterly statements

Companies with US listings are accustomed to releasing quarterly figures. In one such instance discussed at the meeting, which was considered to be an example of ‘best practice’, the full Board saw the quarterly figures and the CEO’s and FD’s presentations thereon in advance of their release and had a chance to comment upon these.

Interim management statements were brought in relatively recently as a result of the EU Transparency Directive. Their structure and content vary between companies, with some being mostly narrative and others being more numerical. Practices encountered by the interviewees ranged from one company where the trading statement was approved by the whole Board, through to another, where there were no formal review procedures at all, although the audit committee chair asked to see the statement before its release. Some companies have not yet established what their procedures will be surrounding the review of the interim statements.

### Corporate website

The company’s website contains much information that may affect the share price. In one company discussed in the interviews, almost everything on the website went through a disclosure committee and was subject to verification. However, this practice appeared to be unusual; most of the audit committee chairs were not aware what procedures were in operation to ensure the probity of their corporate website.

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<sup>2</sup> Earnings Before Interest, Tax, Depreciation and Amortisation.



## Conclusion

*“Ironically, the things we as the audit committee look at are probably less risky than some of the things we don’t look at.”*

The level of non-audited releases is growing, and investors and analysts pay as much attention to these as to the audited figures. Practices for the verification and review of such data have not developed at the same speed as have the disclosures. The Board of directors needs to ensure that systems governing these data are robust, in order to be confident of the probity of market-sensitive information released; this includes financial and non-financial data, and the tone of the words surrounding them.

It is not appropriate, or practical, for the audit committee or the Board to examine every piece of information released by the company. It is for executives to devise suitable processes, and for the audit committee to ensure that these are working appropriately. A hierarchy of oversight is needed, with the audit committee and/or the Board paying particular attention to the tone and content of crucial data.

ACCF members in companies which had disclosure committees were generally satisfied that processes were in place to govern the factual matter underlying the releases. For those without disclosure committees, reliance was placed on the integrity of the finance team and those preparing the data, and on the external and internal auditors.

Some concern was expressed regarding the investor and analyst presentations, where very short timescales in some companies mean that non executives do not get the chance to review the tone and content in advance. It was considered that regulations and standards are not appropriate in this area, as the circumstances of each company and industry will vary considerably. However, a non-regulatory guideline on good practice regarding the review of the content of the investor presentation would be of use, providing helpful information on good practice.



## Questions to Ask Yourself?

1. What non-audited information that could have a market impact is released by my company?
2. What procedures are in place to establish the probity of such information? For example, is there a chain of evidence to back up the disclosed information?
3. Would a disclosure committee be a useful addition to our internal control processes regarding non-audited information? If so, what should be its terms of reference?
4. Are my company's procedures for reviewing the tone of important disclosures sufficiently robust?



## Appendix 1

# Questions Included in the Briefing Paper Supporting the Meeting

1. What is the role of your audit committee as regards non-audited information included in the financial statements?
2. What is the role of your audit committee as regards non-audited information presented outside the financial statements, such as the trading statement, oral presentations to investors, or the company's website?
3. What processes are in place in your company to ensure the probity of such information?
4. How do you see this developing over the next couple of years?

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Question 4 was not addressed directly in the meeting, other than to note the increasing level of non-audited disclosures, and the expectation that this will continue.



## Appendix 2

# Examples of Non-Audited Information, and Regulatory Status

The range of non-audited disclosures a company makes is considerable. Some matters must be disclosed, for example much of the narrative in the financial statements or the interim management statement. Other information is disclosed as a matter of custom and practice, for example the investor presentations. The various types of information are discussed below.

### Annual report and financial statements

Narrative disclosure has for many years been a part of the annual report and financial statements. The Companies Act 2006 (s.417) has formalised this as the Business Review which, for large listed companies, must include the following

#### Summary of contents of the directors' report: business review

- Fair review of the company's business
- Description of the principal risks and uncertainties facing the company
- Balanced and comprehensive analysis of the development and performance of the company's business during the financial year, and its year-end position
- The main trends and factors likely to affect its future development performance and position
- Information on matters of corporate social responsibility such as environmental and employee matters
- Analysis using relevant key performance indicators

Much of this type of information has previously been included in the annual report in the form of the chairman's or chief executive's review or other narrative. However, the Companies Act 2006 introduced a 'safe harbour' provision for the directors' report and the directors' remuneration report, whereby directors are only liable for statements made recklessly or in bad faith.

### Pre-close trading statement

The trading update issued before the company goes into the closed period when it is preparing its annual financial statements has the potential to move market sentiment and significantly affect the share price. Neither the tone nor the underlying information are audited.

### **Preliminary statement**

The preliminary statement issued by the company contains financial information on which, to all intents and purposes, the auditors have signed off. However, technically this is not audited information. Furthermore, the tone of the document, like the tone of the narrative in the annual report, is not audited. The preliminary statement contains information that can move the share price.

### **Investor presentations**

Presentations to investors and analysts comprise material included in the slides used, the narrative that accompanies that material, and responses given to the questions that follow the formal presentation. None of this information is audited.

### **Half-yearly accounts and interim management statements**

The half-yearly accounts are not audited. Nor are the interim management statements brought in as a result of the Transparency Directive: these contain mostly narrative information rather than financial figures.

### **Corporate website**

Much of the information on a company's website has the potential to influence markets. This applies both to the content of the investor relations part of the website, and to the material presented in the more general sections.



## Appendix 3

# The Role of the Disclosure Committee in the USA

The following extract is taken, with permission, from:

Hamilton, J. and Trautmann, T. (2002-3). Responsibilities of Corporate Officers and Directors under Federal Securities Laws, Riverwoods, Illinois: CCH.

In light of the Sarbanes-Oxley requirement that senior corporate executive and financial officers certify that they maintain disclosure controls and procedures designed to ensure that material information is made known to them, the SEC recommends that companies establish a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis.

The disclosure committee would report to senior management, including the principal executive and financial officers, who bear express responsibility for designing, establishing, maintaining, reviewing and evaluating the company's disclosure controls and procedures.

The disclosure committee is technically not a board committee since it will include non-board members, as well as board members. Corporate officers who have an interest in, and the expertise to serve on, the committee could include the principal accounting officer (or the controller), the general counsel or other senior legal official with responsibility for disclosure matters who reports to the general counsel, the principal risk management officer, and the chief investor relations officer.

The Breeden Report calls on the nominating committee, along with the audit committee, to establish and oversee a disclosure committee composed of relevant senior management, external advisors and directors. The report envisions the task of the disclosure committee as reviewing disclosure documents before they are released in order to ensure their clarity and accuracy.

The report to the U.S. District Court for the Southern District of New York on Corporate Governance for the future of MCI, Inc., commonly referred to as the Breeden Report, contained a number of best practice recommendations for nominating/corporate governance committees. The Report, issued in August 2003, was the work of former SEC chairman and MCI corporate monitor, Richard C. Breeden.





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